DICKMEYERBOYCE
FINANCIAL MANAGEMENT, INC.

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Subject: 2017 – Year End Review

The intent of this review is to keep you up to date with some key securities market and macroeconomic happenings. To shorten your reading time, read the bold print and the summary.

Attached you will find a summary perspective on the market and the economy, performance comparison of growth and value stocks by asset class, and your personal portfolio reports including Performance Analysis from inception through December 31, 2017, Portfolio Statement, Index results from 12/31/16 to 12/29/17, and Position Performance Summary from 12/31/16 to 12/31/17. December 29th was the last trading day of the year.

Stock Perspectives / Growth vs. Value

- **A 100% stock portfolio with dividends reinvested was up 21.32% through the end of the year**.
- Value stocks turn in the limelight in 2016 capitulated to growth in 2017. **Growth led Value by 16.48% for the year.**
- **The stock market finished strong as the potential for positive impact of the 2018 Tax Law changes were coming to light.**
- **Valuations are on the high side**, **but growth stocks are skewing overall valuations above the fair value range. Based upon P/E ratios, it would be safe to say that Value stocks as a whole are valued above the mid-point of the fair value range and rising towards the high end, where Growth stocks are valued above the fair value range.** An example of growth causing distorted valuations can be seen in the small cap index. The trailing twelve month P/E ratio is 132, yet if you exclude companies that did not make a profit, the P/E ratio is 26.4
- **Price to book value ratio for Growth stocks is now 39% above the long term average (6.73 vs. 4.83). Price to book value ratio for Value stocks is about 3% above the long term average (2.09 vs. 2.03).**

Bond Market

- **The Federal Reserve wants to steer interest rates very gradually upward. The good news is that the Fed is confident that the U.S. economy is on solid footing.** Historically, when raising interest rates to combat inflation, the Federal Reserve raises interest rates at a rate of 1% per year done in steps of 0.25%. The Fed raised the Federal Funds rate (rate at which banks lend each other money over-night) by 0.25% in December 2015, in December 2016, also in March, June, and December of 2017. The bond market had a mind of its own for most of 2017. **In spite of the March and June increases, intermediate and long term bond yields declined for most of the year. The decline in yields (bond prices up) was driven by strong foreign demand for U.S. bonds as rates in Europe and Japan are extremely low to negative.** Since the March increase, the 10 year Treasury rate had declined from 2.60% to 2.35%. Despite the Fed's three rate increases, short term bonds were up 1.84% for the year and intermediate bonds (Barclays Aggregate) were up 3.73%. This contrary reaction to raising the Fed Funds rate points to a dilemma for the Fed. They feel the need to raise interest rates to fend off higher inflation, yet the act of doing so attracts foreign demand for intermediate and long term U.S. bonds, which drives bond yields down. This results in a flatter yield curve (smaller spread between short and long term interest rates). This is not an outcome the Federal Reserve wants to achieve, as a flatter yield curve would cause earnings problems for banks and therefore a reduction in lending from banks. The 10 year treasury was at 2.40% around the time the tax law was signed by President Trump, now it is back up to 2.66%. **This recent rise in the 10 year Treasury rate must be very welcome in the eyes of the Federal Reserve as well as banks seeking to lend.**

- **The Fed is targeting three increases in the Federal Funds rate this year. A fourth increase may become necessary if inflation heats up due to an economy gaining strength and with the added fuel provided by the tax law changes. Still, the Fed has embarked on a very gradual path of interest rate increases to arrive at a point of interest rate normalization, which may be 1.5% below historical norms. This is consistent with our lower for longer view of interest rates. This makes for a difficult environment for bond/income investors - but, good news for borrowers.**
- In addition, the Federal Reserve began reducing their balance sheet of U.S. Treasury bonds and mortgage backed bonds in October. Their plan to tighten money supply, from an extremely loose level, is very gradual.
- **We continue to focus on lowering the interest rate risk in bond portfolios by increasing the portion in short term bonds and lowering the portion in intermediate or long bonds. Also, we continue to focus on bond funds with interest rates higher than duration in order to protect against falling bond prices / rising interest rates.**

Data and Commentary

- 2016 Real GDP growth: 1.6%
- 1st Quarter 2017 Real GDP growth: final reading was 1.2%.
- 2nd Quarter 2017 Real GDP growth: final reading was raised to 3.1%.
- 3rd Quarter 2017 Real GDP growth: final reading was 3.2%, in spite of the two hurricane punch.
- 4th Quarter 2017 Real GDP growth: first estimate was 2.6%.
- **Real GDP growth in 2017 was 2.3%. That is up from 1.6% in 2016. Estimates for 2018 GDP growth are running at 2.7%.** The International Money Fund (IMF) just raised their forecast for real GDP growth in the U.S. from 2.3% to 2.7%. The IMF also raised the world forecast for real GDP growth from 3.7% to 3.9%. The IMF sited the U.S. tax law changes as the reason for their increased forecast.
- **Let us look around the world.**
    - **Eurozone real GDP growth was likely to have been 2.5%, the fastest pace in a decade. Their economic expansion is now 19 consecutive quarters long.** Last month, the International Monetary Fund said Europe's recovery was so strong it's spilled out into the rest of the world, making the region an "engine of global trade" and economic growth.
    - **China's real GDP growth rose from 6.7% in 2016 to 6.8% in 2017. The biggest near term issue for China is high corporate debt. It is 160% of GDP. For comparison purposes, U.S. corporate debt to GDP is 30.7%.**

- **Japan's 3rd quarter GDP growth was a surprising 2.5%. This is their 7th quarter of growth in a row. This is a two decade record. The growth appears to have remained strong in the 4th quarter.**
- **All major world economies expanded in 2017. This last occurred in 2005 thru 2007. Prior to that was 1987 and 1989. Simultaneous worldwide expansion is fairly rare and tends to be self-reinforcing. Even Greece had GDP growth in 2017.**
- **85% of the countries in the world had expanded exports in 2017.**

- Quarterly corporate results are grabbing more headlines. **Rewards (or penalties) of sales and earnings growth success (or lack thereof) are having greater sway over individual stock results, as opposed to an environment of a tide raising all boats. 77% of companies (this is more than normal, the five year average is 56%) that have reported 4th quarter sales earnings are exceeding expected gains. Earnings are exceeding 2016 levels by 12.4%.**
- **We are in the midst of the third longest bull market in the history (back to 1850) of the USA. 19 more weeks to tie the record. The conditions that normally lead to significant market decline are either not present or not forecastable, including an oncoming recession, a hostile Federal Reserve, dangerous inflation, investor exuberance, speculative valuations or a geopolitical shock.**
  - **The Federal Reserve is the opposite of hostile. The Fed is actually very accommodative. Newly appointed Fed Chair, Jerome Powell is telegraphing little change in policy with the exception of a lighter hand on regulation.**
  - **Dangerous inflation is not on any radar. There are concerns that the 2018 tax law changes may add too much fuel to the economy.**
  - **Investor exuberance: Famous investor John Templeton argued that "bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria". This market does not resemble the euphoria of the dangerous years of 1929 or 2000. Since this bull market began individual investors pulled money from stock mutual funds every year until the last two years. The inflow in 2016 and 2017 has not been exceptional by any means. We would estimate we are entering the optimism phase.**
  - **Speculative valuations are present in some well-known growth stocks as well as some young biomedical companies. Growth stocks as a whole are more than modestly overvalued. Speculative valuations certainly are not as pervasive as they were in the late 1990's.**
  - **Geopolitical shock: North Korea. Keep an eye on trade policy.**
  - **Oncoming recession: Not in view at this point. We are in a rare period of simultaneous worldwide economic growth. Recessions normally are the byproduct of excessive imbalances. Because of the slow growth since the Great Recession, they have been slow to materialize.**
- **Economic Indicators: Normally we go in depth into statistics dealing with leading and coincident indicators – we will try to limit the commentary. You will find a case for continued economic growth.**

- **Consumer spending rose 3.3% for the year and 3.8% annualized rate in the 4th quarter of 2017. This rate exceeds GDP growth.** Consumer spending accounts for just over of 69% of GDP. Consumer spending has been slow to recover from the great recession, but it is now gaining pace. Many analysts look to the Consumer Confidence Index to predict how likely it is consumers will spend. That's because people are more likely to shop when they feel confident about their ability to get a better paying job.
- Consumer confidence has been gradually trending up since July 2007. **The consumer confidence reading hit a 17 year high in October at 125.9, November was 128.6, and December was 122.1.**
- **The Personal Savings Rate has declined from 11% in 2012 (highest reading since August 1982) after the financial crisis to 2.4% in December.** This is a sign that personal balance sheets (net worth) have recovered from the financial crisis. It is also an indication that individuals are feeling wealthy with the recovery of their investments and real estate. **But, it is a concern in that future spending increases could be constrained unless pay increases and employment continues to grow. Both are likely.**
- **Housing demand is strong, but growth may be leveling off due to a lack of supply**: Building permits and housing starts were up 9% in 2017. Existing home sales were up 1.1% in 2017 to the highest level since 2006. A lack of supply, which is down to a record level of just 3.2 months (6 months inventory is a balanced level for buyers and sellers), has driven home prices up 5.8% in 2017 which is above 2006 levels. Building should be increasing at a greater rate, but a shortage of skilled labor and high development costs stand in the way. Mortgage rates remain low, but affordability has become an issue. Spending on home upgrades and remodeling is hitting record levels due to the shortage of existing homes for sale.
- **Commercial construction was forecast to have grown by 3.8% in 2017 and is forecast to grow 3.6% in 2018.**
- **Business investment increased 7.5% in 2017 after declining in 2015 and 2016. Subsequent to passage of the 2018 tax law changes, 245 corporations have announced investment plans in the USA, employee compensation increases, and/or plans to return cash to investors.**
- **Institute of Supply Management: Readings above 50 means growth.** Readings above 60 are rare.
    - Institute of Supply Management - **Manufacturing: 60.8, 58.7, 58.2, and 59.7. September (a 13 year high) thru December readings, respectively.** Manufacturing has been on a strong up-trend for the last 18 months. **Historically, this level correlates to 4.5% GDP growth. We are not suggesting that this kind of growth is in the cards. But, it gives you an idea of how elevated this reading is.**
    - Institute of Supply Management – **Service: 59.8, 58.7, 57.4, 55.9. September (highest reading since August 2005) thru December readings, respectively.** Readings have been above 50 since early 2010. The readings for 2017 range from 55.2 to 59.8.

- **Employment**
    - **Monthly hiring remains strong:** 2016 average was 180,300. 2017 average was 170,500.
    - **The four week moving average for unemployment claims finished the year at 240,000. This reading has been below 300,000 for 152 weeks in a row. Readings below 300,000 point to continued substantial monthly hiring.**
    - **A review of the unemployment, underemployment, and the labor force participation rate indicates that we are still 3.4% away from full employment.**
- **Orders for durable goods picked up the pace in 2017.** Historically, this is a volatile reading. It has averaged 0.33% monthly gains since 1992. In 2017, we averaged 0.84% per month.
- **Corporate earnings growth is strong. Corporate tax rate reduction would add fuel to the fire.**
- **Financial Stress Index is very low (lack of stress).** The average reading in 2017 was negative 1.42. Negative 1.0 is a very low reading, meaning **positive for the economy**.
- **Strength of the Dollar: Presently, the relative decline in the value of the dollar has been a net positive for manufacturing and exports. The dollar has continued to decline by an additional 3% in early 2018.**

<u>Summary / Conclusion</u>

- Economically, the positives significantly outweigh the negatives. Leading economic indicator trends are strong. We are in a rare period of synchronized worldwide growth.
- We will keep an eye on rising inflation. A lack of increase in the employment participation rate would likely be evidence of the tip of the iceberg.
- Absent geopolitical risks, one can envision an even longer extended period of economic growth. Actually, a pick-up in the growth rate seems likely.
- Portfolio performance results: Bonds have bested the short and intermediate term indexes. In light of the outperformance of growth, Equities have trailed their respective index, but have beaten the value vs. the stock index spread.
    - Side note: Last year, we had changed our reports to include Cash in the Fixed Income asset class. The data base tries to exclude the movement of Cash in its calculations. The inclusion of Cash in Fixed Income has caused some erroneous Fixed Income asset class return calculations. This does not impact your over-all portfolio return calculations or the Fixed Income Sector return for Short Term Bonds, Intermediate Term Bonds, Long Term Bonds, and High Yield Bonds. We have gone back to excluding Cash from the Fixed Income asset class for purposes of the Fixed Income asset class return calculation for 2018 and beyond.
- We remain focused on the long view of value investing and seeking income as well as long term appreciation of investments. Our focus on the status of the economy is not directed at seeking market exit and entry points. Rather, it is intended to help us target potential tactical adjustments to portfolios.
- While we are monitoring the economy and the risks to equity and bond markets, periods of decline are unavoidable. Nothing can replace the decisions / choices you make with regard to growing your wealth

over the long term.

Additional Comment

- Most of the data we review on a regular basis is macro-economic. It provides a high level review of the economy. That does not mean the data applies to every person. We read an editorial about a month ago, that pointed out 40% of Americans have not fully recovered from the financial crisis. We don't know if the number is correct, but we don't doubt that it is significant. In addition, unemployment rates in Europe and Emerging countries are still quite high. This makes us cheerleaders for continued synchronous gains for the world economy. It also causes us to be on the look-out to assist those in need of a hand up.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

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